



March 2007

Use of Loan Savings for Emergency Rehabilitation and Reconstruction of Earthquake-Affected Areas in Pakistan

Asian Development Bank

I. INTRODUCTION

1. The Government of Pakistan (the Government) has requested Asian Development Bank (ADB) approval for the cancellation of surplus funds in the Second Science Education Sector Project¹ at an amount of special drawing rights (SDR) equivalent to \$12.5 million and their use as quick-disbursing support for the reconstruction of affected areas after the South Asia earthquake of October 2005. The cancellation of loan savings under the Second Science Education Sector Project has been approved based on the memo of the Pakistan Resident Mission (PRM) dated 7 August 2006, in accordance with para. 12 of Project Administration Instructions (PAI) No. 4.04². The cancellation of loan savings will be effected upon approval by ADB's Board of Directors (the Board) to reallocate and transfer these funds to earthquake rehabilitation and reconstruction activities. Reallocation will take place immediately upon cancellation. To effect the transfer of these loan savings to earthquake rehabilitation and reconstruction efforts as requested by the Borrower, it is proposed to use the Emergency Earthquake Assistance Project (EEAP)³ to absorb these surplus funds. The proposal for Board approval to redirect loan savings to a disaster and emergency assistance project is in accordance with the *Disaster and Emergency Assistance Policy*,⁴ *Operations Manual* Section H6 (Use of Surplus Loan Proceeds), and PAI 5.06⁵. It is also in line with the Government's earlier request for approval of loan savings from eight Asian Development Fund (ADF) loans of up to an amount of \$105 million equivalent to be used as quick-disbursing support for earthquake rehabilitation and reconstruction⁶ activities.

II. BACKGROUND

A. Background

2. On 8 October 2005 an earthquake measuring 7.6 on the Richter scale struck Afghanistan, India, and Pakistan. The epicenter was 100 kilometers north of Islamabad, the capital of Pakistan. Damage caused in Pakistan was in the eastern districts of the North-West Frontier Province (NWFP) and Islamabad, and in Azad Jammu and Kashmir (AJK).⁷ By official estimates 78,000 people died in the earthquake, about 80,000 were severely injured or disabled, more than 600,000 housing units were damaged or destroyed, and over 4 million people were affected by death, injury, or loss of shelter. The cost of reconstruction and relief over the next 3 to 5 years is estimated at \$6.2 billion.

¹ ADB. 1997. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Islamic Republic of Pakistan for the Second Science Education Sector Project*. Manila. (Loan 1534-PAK[SF], for \$40 million, approved on 11 September.)

² ADB. 2004. *Suspension and Cancellation of Loans*. *Project Administration Instructions*, No. 4.04. Manila.

³ ADB. 2005. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Islamic Republic of Pakistan for the Earthquake Emergency Assistance Project*. Manila. (Loan 2213-PAK[SF], for \$200 million, approved on 13 December.)

⁴ ADB. 2004. *Disaster and Emergency Assistance Policy*. Manila (Doc. R71-05).

⁵ ADB. 2001. *Utilizing Surplus Loan Proceeds*. *Project Administration Instructions*, No. 5.06. Manila.

⁶ ADB. 2005. *Use of Loan Savings for Emergency Rehabilitation and Reconstruction of Earthquake-Affected Areas in Pakistan*. Manila (R302-05, approved on 14 November.)

⁷ Azad Jammu and Kashmir is an area over which Pakistan and India have been in dispute since 1947. By providing the proposed assistance, the Asian Development Bank does not intend to make any judgment as to the legal or other status of any disputed territories or to prejudice the final determination of the parties' claims.

3. As a result of the damage caused, a substantial increase is expected in public sector expenditure over the next 3 to 5 years which will adversely affect the Government's budgetary position, fiscal deficit, and external current account deficit. The Government's requests for reallocation of loan savings from ADF loans towards quick-disbursing support are to help finance increased public sector expenditures and the resultant fiscal gap without causing inflation.

4. The earlier request for approval to reallocate loan savings from eight ADF loans towards the earthquake rehabilitation and reconstruction effort was approved on 14 November 2005 (footnote 6). Board approval encompassed the cancellation of up to \$105 million from the eight ADF projects and the transfer of up to \$105 million to Loan 1936-PAK(SF):Decentralization Support Program⁸ (DSP). An amount of \$85 million was disbursed and the remaining balance (depending on the available savings in the eight identified loans) was to be released before 30 June 2006, the closing date of DSP. However, the remaining balance of \$20 million did not materialize before closing of DSP, due to the non-availability of further loan savings.

B. Government's Response

5. The Government mobilized the armed forces to take the lead in the emergency effort and made special arrangements to assist national and international civil society organizations and donor agencies. Immediate expenditures related to the emergency operations were financed out of Rs5 billion announced for the purpose. A President's Relief Fund received donations of over Rs5 billion of which Rs2 billion were immediately provided to the governments of AJK and NWFP. An Earthquake Reconstruction and Rehabilitation Authority (ERRA) was established with the responsibility of guiding reconstruction work and undertaking strategic planning in the affected districts.

C. ADB's Response and Strategy

6. At the international donors' conference on earthquake reconstruction and rehabilitation held in Islamabad on 19 November 2005, ADB President Haruhiko Kuroda pledged an amount of up to \$1 billion to Pakistan in concessional funds (ADF) and grants for reconstruction and recovery assistance. On 14 November 2005, ADB's Board approved the transfer of up to \$105 million from loan savings to the DSP for earthquake assistance. The same day, the Board also approved the establishment of the Pakistan Earthquake Fund (PEF) with an initial contribution from ADB of \$80 million in grant financing. To date, ADB has mobilized an additional \$75 million from bilateral donors using the PEF mechanism for delivering grant assistance. ADB's Earthquake Emergency Assistance Project was approved on 13 December 2005 for \$300 million, comprising the \$80 million grant funds and a loan of \$220 million from ADF. Out of this \$300 million, \$100 million was disbursed for quick-disbursing assistance to finance the unusually high expenditures resulting from the earthquake. An additional grant of \$5 million was approved by ADB on 27 March 2006 from the Japan Fund for Poverty Reduction.

7. ADB has also reallocated funds and adjusted the implementation arrangements of three ongoing projects⁹ in the earthquake-affected areas to effectively address damage caused by the

⁸ ADB. 2002. *Report and Recommendation of the President to the Board of Directors on the Proposed Program and Technical Assistance Loans to the Islamic Republic of Pakistan for the Decentralization Support Program*. Manila. (Loan Nos. 1935-PAK and 1936-PAK [SF], for \$270 million, approved on 11 November).

⁹ ADB. 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Islamic Republic of Pakistan for the NWFP Barani Area Development Project – Phase II*. Manila. (Loan 1787-PAK[SF], for \$52 million, approved on 28 November); ADB. 2000. *Report and Recommendation of the President to*

earthquake. This includes the creation of an Emergency Livelihoods Restoration Fund from the Community Infrastructure and Micro Finance Social Development Funds of the Microfinance Sector Development Project. Assistance through new and ongoing ADB loans is designed to operate in a mutually reinforcing manner, to achieve the objective of mitigating the devastation caused by the earthquake and rehabilitating and reconstructing priority infrastructure.

III. IMPLEMENTATION ARRANGEMENTS

8. In accordance with the *Disaster and Emergency Assistance Policy* (footnote 4), and PAI 5.06 (footnote 5), the loan savings from the Second Science Education Sector Project (footnote 1) will be cancelled and reallocated to EEAP, as requested by the Government. Reallocation will be effected immediately following cancellation. There is no requirement to modify the scope of EEAP to accommodate this transfer of funds since it has been created for the same purpose and the new allocation will augment the quick-disbursing funds under EEAP. Items eligible for financing under the quick-disbursing modality are those imports identified as necessary for an effective recovery program; these are listed in the EEAP Financing Agreement. Disbursement of the loan savings will be through withdrawal applications submitted by the Government, and will follow the existing disbursement procedures of EEAP. The Ministry of Finance is the executing agency for the quick-disbursing component. A letter of agreement to be signed between ADB and the Government will reflect the cancellation of loan savings from the Second Science Education Sector Project and their allocation to EEAP. The letter of agreement will specify that all other conditions within the Financing Agreement of EEAP, including existing governance, disbursement, and auditing and accounting arrangements, will apply to the loan savings. The adjustments to loan amortizations and repayment amounts will be consistent with the arrangements with respect to the \$85 million earlier cancelled as loan savings and re-directed towards earthquake rehabilitation and reconstruction.

9. The vehicle of EEAP for redirecting the surplus loan proceeds towards earthquake rehabilitation and reconstruction is considered appropriate given the similarity of purpose and the need for a quick-disbursing modality, as provided for under EEAP.

IV. BENEFITS AND RISKS

A. Benefits

10. Recent experience in disaster mitigation points to the need for mechanisms other than traditional projects, which preclude a quick response. The quick-disbursing modality allows for funds to be provided to the Government immediately. This is essential given the scale of the disaster and the need to capitalize on the opportunity to accelerate reconstruction before the advent of the next cold season. The quick-disbursing modality also provides the Government with the flexibility to allocate counterpart rupee proceeds for emerging priority needs and a non-inflationary means of financing the large budgetary expenditures. The need to reduce public sector development expenditures will also be curtailed, thereby protecting regular economic growth and social sector spending at national level.

the Board of Directors on a Proposed Loan to the Islamic Republic of Pakistan for the Microfinance Sector Development Project. Manila (Loan 1806-PAK[SF], for \$80 million, approved on 13 December); ADB. 2004. Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Islamic Republic of Pakistan for the Multisector Rehabilitation and Improvement for Azad Jammu and Kashmir Project. Manila (Loan 2153-PAK[SF], for \$76 million, approved on 21 December).

B. Risks

11. There is a risk that counterpart loan proceeds may not be used effectively, particularly in view of the impact of the earthquake on the human and institutional capacity of government institutions to undertake the required reconstruction activities in the affected areas. Effective and ongoing support and coordination between the federal Government and the Governments of AJK and NWFP in the implementation of reconstruction and recovery activities will mitigate this risk. The involvement of national and international civil society organizations will also help to counter the effects of capacity constraints, as will capacity building support from other bilateral and multilateral organizations.

12. Quick-disbursing assistance carries the risk of mismanagement of funds and corruption. However there are significant improvements being made in financial reporting, internal control, external audit, and legislative oversight. The Government's commitment to reforms in public financial management and the implementation performance of other quick-disbursing assistance such as the DSP also give a measure of confidence. Given the emergency nature of the proposed assistance, the financial management arrangements for the emergency tranche are considered satisfactory.

V. THE PRESIDENT'S RECOMMENDATION

13. The President recommends that the Board approve the proposed reallocation of loan savings in an amount in SDR equivalent to \$12.5 million from the Second Science Education Sector Project to the quick-disbursing component of the Earthquake Emergency Assistance Project for emergency rehabilitation and reconstruction of earthquake-affected areas. If the proposed reallocation is approved, the Financing Agreement for the Earthquake Emergency Assistance Project will be amended as appropriate to reflect the change.